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Phoenix, Arizona 85007

Arizona Corporation Commission
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Re: Arizona Public Service Company General Rate Case; Docket Nos. E-01345A-05-0816, E-01345A-05-0826, E-01345A-05-0827; Staff Report dated January 29, 2008

Dear Commissioners:

The purpose of this letter is to respond to the Staff Report dated January 29, 2008 in the above matter. Arizona Public Service Company ("APS" or "Company") is appreciative of both the Commission's desire to creatively address the high costs of growth and the comprehensive effort made by Arizona Corporation Commission ("Commission") Utilities Division Staff and its consultant (collectively referred to as "Staff") to identify and frame the policy issues presented by Schedule 3.

There are many statements contained in the Staff Report with which the Company takes no issue. These include:

1. The changes to Schedule 3 ordered by Decision No. 69663 were initiated by the Commissioners themselves rather than in response to a specific recommendation by a party (Staff Report at 3). Thus, the Commission is in the best position to determine what it intended by directing such changes.

2. The Commission did not, in Decision No. 69663, indicate how the proceeds from Schedule 3 were to be treated for accounting purposes (Id). As discussed in the Company's letter to the Commission of December 20, 2007 and its Exceptions to the

Staff's Recommended Order, Schedule 3 proceeds are currently (and have been for some time) variously accounted for as contributions-in-aid of construction ("CIAC"), refundable advances, and revenue.

3. CIAC will offset significant capital financing requirements and provide a measure of eventual cost savings to APS customers (Staff Report at 4).

4. Approval of the revenue treatment, as proposed by APS, will benefit APS by improving earnings and other financial metrics (Id).

5. This, in turn, would benefit APS customers to the extent it: (a) lowered future capital costs of APS; and/or (2) deferred the filing of the next APS general rate case (Id).

6. There is a "cross-over" point at some distant future date at which point the advantages to APS customers in the form of lower future revenue requirements (not necessarily lower rates, however, as will be explained below) of CIAC treatment are greater than under the Company's revenue proposal (Staff Report at 5-6).

7. Treatment of Schedule 3 proceeds as "cost-free" capital is less advantageous than either CIAC or the Company's proposed revenue credit (Staff Report at 7-8).

8. Net present value ("NPV") analysis is an appropriate means of evaluating long-term impacts of the two proposals on APS revenue requirements (Staff Report at 1).

9. Present value analysis should not be determinative of what is essentially a policy decision by the Commission (Staff Report at 1 and 13).

These areas of agreement aside, APS does respectfully disagree with the Staff Report's failure to attribute sufficient (if any) consideration to the value to APS customers and the Commission of deferring or reducing the next APS general rate filing, its equation of the current APS proposal with regard to Schedule 3 with the Company's rebuttal position in the most recent APS rate proceeding, its other criticisms of the revenue approach (especially including its alternative suggestions of a revenue credit deferral or immediate rate reduction), and finally its quantitative analysis of the two proposals before the Commission.

1. Impact on Timing of Next APS General Rate Filing

The Staff Report agrees that: "It is much less likely that APS' *next* rate case will be significantly delayed under the CIAC approach." (Staff Report at 6 - emphasis in original.) Staff then dismisses that clear benefit to both APS customers and the Commission as something that is "impossible to quantify" (Staff Report at 4), and thus appears to give the potential for such a rate case deferral, or at the very least its mitigation, little or no weight in making its recommendation. APS believes that omission fails to reflect the clear intent of the Commission in Decision No. 69663, which was to make growth pay for what everyone acknowledges are the higher costs of service rather than current APS customers. Thus, it was precisely that next APS rate case that the Commission wished delayed or reduced as much as possible.

2. The Company's Proposal Regarding Schedule 3 is Not Comparable to its Rebuttal Proposals in the Last APS Rate Case

At page 13 of the Staff Report, Staff asserts that:

> The negative impact on customers from adopting APS' [Schedule 3] proposal in this instance would be at least as great as it would have been for the Commission to have adopted the [Company's] proposed attrition allowance and certainly greater than would have been the case if the Commission has adopted CWIP in rate base or accelerated depreciation as proposed during the rebuttal phase of the [last] rate case.

APS disputes that any of its proposals in the last rate case would have had a negative effect and certainly does not equate giving the Company a fighting chance to actually earn the return found reasonable by the Commission to be a "negative impact."

However, if Staff means that the Company's Schedule 3 proposal would have the same immediate impact on customer rates as the revenue enhancements suggested in this rate proceeding, that is not the case. Unlike ANY of the proposals recommended by APS in its rebuttal testimony, the revenue treatment of Schedule 3 proceeds would not require an increase in the base rates approved by Decision No. 69663. Neither would it increase the amounts paid by new service applicants under Schedule 3 as compared to the Staff recommendation. Under both the Staff and APS proposals, there would be no impact on the base rates established in Decision No. 69663.

3. Other Alleged "Disadvantages" of Revenue Treatment of Schedule 3 Proceeds

At pages 5 and 6 of the Staff Report, Staff lists the "disadvantages" of revenue treatment and the "advantages" of CIAC. In summary, the Staff Report alleges:

a. The benefits of revenue treatment to the Company's financial condition are short-lived.

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b. Schedule 3 revenues would be volatile.

c. There is a "cross-over" point at which CIAC treatment is more favorable.

Conversely, Staff contends that:

a. Because the measure of anticipated Schedule 3 proceeds is tied to future construction, it is just more "appropriate" from a "conceptual" point of view to treat them as CIAC.

b. APS should have less attrition over both the short and long run if Schedule 3 proceeds are treated as CIAC.

c. There is "cross-over" point that in Staff's opinion provides a better matching of costs.

d. The presumed "volatility" of Schedule 3 proceeds is less of an issue if it is treated as CIAC.

The Staff Report's first supposed "advantage" of CIAC confuses how a Schedule 3 fee is determined quantitatively with how it should be accounted for, once received. As was also discussed in the Company's December 20th letter, Schedule 3 fees could just as easily be assessed on a flat per customer basis. Schedule 3 fees were linked on a dollar basis to the level of construction costs for two reasons: (1) consistency with the literal language of Decision No. 69663; and (2) this approach would make service applicants indifferent to whether the fees were accounted for as revenue or CIAC.

The Staff Report's second listed CIAC "advantage" needs to be examined in conjunction with the first claimed "disadvantage" of revenue treatment. Staff concedes that revenue treatment as requested by the Company will enhance APS's financial condition between now and whenever the Company's next rate case is decided. How "short term" that period is largely depends on the accounting afforded Schedule 3 proceeds. In contrast, CIAC does little to address the ongoing earnings and financial attrition that APS faces over the next several years. Moreover, revenue treatment provides for a steady growth in this revenue stream even after the next rate proceeding, thus serving to partially offset subsequent attrition and lengthen the time between APS rate cases in general.

APS has already addressed the "cross-over" issue, and therefore turns to the so-called "volatility" criticism. The Staff Report cites the Company own revenue estimates of between $50 million and $159 million over a three-year period as "evidence" of such volatility. (Staff Report at 5.) However, the Staff Report ignores that the phase-in of Schedule 3 endorsed by Staff causes most of

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this "volatility." The remainder of the difference in revenue amounts over this period is less about volatility than the current difficulty in predicting how fast the housing market will recover. However, no one is arguing that it will not recover or that the APS service territory will not continue to grow at a roughly 3% pace over the long term. Moreover, if this "volatility" concern is shared by the Commission, it can easily be addressed by instituting some manner of "balancing account" measure by which the revenue credit amount used in setting rates in some future APS proceeding can be reconciled, up or down, depending on the level of actual Schedule 3 proceeds received thereafter.

In the table below, APS has summarized what it believes are the salient differences between the revenue credit and CIAC alternatives:

	Revenue	**CIAC**
Amount Received by APS From Schedule 3 Applicants	Same	Same
Can Defer or Significantly Reduce the Size of the Next APS Rate Case	Yes	No
Improve FFO/Debt Ratio and thus Reduce Possibility of a Credit Downgrade	Yes	No
Improve APS Financial Metrics other than FF0/Debt	Yes	Yes, but only marginally
Makes Growth Pay for Self	Yes	Yes, but only partially
Present Value Savings to APS Customers	Yes	Yes, but significantly less than under revenue treatment

Although the Staff Report strongly endorsed the CIAC alternative, it did raise the specter of seemingly allowing revenue treatment of Schedule 3 proceeds, but deferring all of that benefit (but <u>none</u> of the higher costs incurred by APS that such proceeds were intended to mitigate) until the conclusion of a future rate proceeding or even currently reducing the rates established by Decision No. 69663. The Staff Report's alternatives of some manner of revenue credit "deferral" or rate reduction would be worse than CIAC in every respect. They would <u>not</u> require growth to pay for itself nor, by Staff's own admission, match costs with benefits. They would <u>not</u> delay the next rate filing, but rather would accelerate the Company's need for immediate rate relief. Simply stated, they would result in <u>no</u> revenue to APS at all, <u>no</u> improvement (in fact, a <u>decline</u> both immediately and in the future) in the

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Company's current financial condition, and would not provide even the modest long-term benefits of CIAC.

4. Quantitative Issues

Staff's present value analysis is what APS refers to as a "static" analysis. It looks at a specific dollar of CIAC/revenue over a 30-year period but assumes that revenue treatment would not continue after year one. It assumes no increase in Schedule 3 proceeds from year-to-year and annual rate resets with zero regulatory lag. As APS noted in its letter of December 20, 2007, the "cross-over" point is extended further into the future (and the present value of revenue treatment to customers increased) depending on the growth in Schedule 3 proceeds, the frequency of rate cases, and the degree of regulatory lag.

APS assumed a 5% growth in Schedule 3 revenues, continuation of revenue/CIAC treatment over the entire period, a new rate order every three years, and zero regulatory lag – very conservative assumptions. *See* APS Letter of December 20, 2007 at 5. Staff's assumptions of no continuing and, indeed, zero growth in Schedule 3 proceeds, and annual rate decisions, combined with no regulatory lag are simply unrealistic and explain the apparent discrepancy in the present value analyses of APS and Staff.

Staff has also criticized the Company's computations, contending: "In a nutshell, APS' 10-year and 30-year multi-vintage NPV analyses inappropriately and unfairly calculate revenue requirement savings under the revenue approach over a different period than is calculated under the CIAC approach." Staff Report at 9. Such criticism is inaccurate. APS has utilized exactly the same period for both revenue and CIAC. And while it is true that CIAC received in, say, year 30 will have ongoing benefits (in the form of lower revenue requirements) in years 31, et seq., the same is also true of Schedule 3 revenues received in years 31-60. The chart shown at page 10 of the Staff report ignores that fact and, instead, shows Schedule 3 revenues as zero for years after the period analyzed. In other words, Staff compares the benefits received from 10 or 30 years of CIAC over a 40 or 60-year period to the benefits of revenue over just the 10/30 year period – the very mismatch it alleges exists in the Company's analysis.

Finally, both the Company's and Staff's NPV analyses may not fully capture the benefits to customers of a lower revenue requirement in the next decade plus. In the nearer term, APS will have fewer customers and fewer kWh sales than say, 15 years from now. Thus, lower revenue requirements today can have a greater benefit per customer than an even lower revenue requirement impact in the distant future because the latter is spread over far more customers and kWh.

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Staff has filed two reports on this matter, and APS has submitted its response to both of them, as well as responses to questions and comments posed by the Commissioners and other parties to these dockets. APS also previously provided specific amendatory language to Staff' Recommended Order, a copy of which amendment is attached for the convenience of the Commission and the other parties. The issues have been framed, the analyses conducted, and the various policy considerations argued. As the Company observed in the December 20th letter, every day that passes reduces the eventual APS customer benefit from either CIAC treatment (as proposed by Staff) or revenue treatment (as proposed by the Company). APS would therefore respectfully suggest that the time has come for decision and would urge the Commission to consider this matter at its earliest convenience.

Sincerely,

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[AS FILED WITH APS EXCEPTIONS DATED NOVEMBER 16, 2007]

APS PROPOSED AMENDMENT

Page 2 Line 11:

DELETE: "Therefore" through "tariff"

Page 2 Line 12:

DELETE: "continue to"

Page 2 Lines 13 and 14:

DELETE: entire sentence beginning "If APS wants"

REPLACE WITH: "We disagree with Staff and note that treating the payments received from Schedule 3 as revenue rather than CIAC will best serve the Commission's intent in Decision No. 69663 'to shift the burden of rising distribution infrastructure costs away from the current customer base to growth.'"

Page 2 Lines 26-27:

DELETE: ", amended to include" through "No. 6,"

Page 3 Line 3:

DELETE: "with" through "No. 6"

MAKE ALL CONFORMING CHANGES.